Supreme Court, U. S.
FILED
MAR 8 1978
MICHAEL RODAK, JR., CLERK

No. 77-917

In the Supreme Court of the United States

OCTOBER TERM, 1977

WHITESIDE & COMPANY, ET AL., PETITIONERS

v.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. AND SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

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OPINIONS BELOW

The opinion of the court of appeals (App., *infra*) is reported at 557 F. 2d 1118. The opinion and order of the Securities and Exchange Commission (Supp. App. 121–127) [1] are not reported.

JURISDICTION

The judgment of the court of appeals was entered on August 18, 1977 (Pet. App. A1). A petition for re-

[1] The Commission's opinion and order appear in the supplemental appendix filed by the Commission with the court of appeals, a copy of which has been lodged with this Court. This appendix will be cited as "Supp. App."

hearing was denied on September 23, 1977 (Pet. App. A5). The petition for a writ of certiorari was filed as of November 21, 1977. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether respondent National Association of Securities Dealers, Inc. ("NASD") properly imposed sanctions on petitioners for their failure to make timely deposits to their special reserve account for the benefit of customers, in violation of Securities Exchange Act Rule 15c3–3(e), and for their failure to provide immediate telegraphic notice of these omissions to the Commission, the Securities Investor Protection Corporation ("SIPC") and the appropriate regulatory authority, in violation of Securities Exchange Act Rule 15c3–3(i).

STATEMENT

Petitioner Whiteside & Company is a broker-dealer registered with the Commission pursuant to Section 15(b) of the Securities Exchange Act of 1934, 48 Stat. 895, as amended, 15 U.S.C. 78*o*(b). Petitioners Clarence K. Whiteside and William H. Whiteside are the company's two registered principals. Respondent NASD is a self-regulatory securities association registered with the Commission pursuant to Section 15A(a) of the Act, as added, 52 Stat. 1070, and amended, 15 U.S.C. 78*o*–3(a). At all relevant times, the company has been a member of the NASD, and, since February 1, 1974, it has also been a member

of the Midwest Stock Exchange ("MSE"), a national securities exchange registered with the Commission pursuant to Section 6(a) of the Act, 48 Stat. 885, as amended, 15 U.S.C. 78f(a) (Supp App. 121, 123, n. 8).

Pursuant to its authority under Section 15(c)(3) of the Act, 15 U.S.C. 78*o*(c)(3), the Commission has promulgated Rule 15c3–3, 17 C.F.R. 240.15c3–3, entitled "Customer protection—reserves and custody of securities." Rule 15c3–3(e) requires every broker or dealer to establish a "Special Reserve Bank Account for the Exclusive Benefit of Customers." The purpose of this account is to ensure that each broker or dealer retains adequate funds to cover indebtedness to customers.

Under the rule, every broker or dealer must make periodic computations pursuant to a specified formula. Smaller brokers or dealers, such as petitioners, are permitted to make the computations on a monthly, rather than a weekly, basis. If the monthly computation shows a net credit balance, *i.e.*, if the broker or dealer owes customers more than they owe him, the broker or dealer is required to deposit in the special reserve account an amount sufficient to make the balance in that account at least 105 percent of the net credit balance.

If such a deposit is necessary, Rule 15c3–3(e)(3) requires that it be made no later than one hour after the opening of banking business on the second business day following the last business day of the month. If such a deposit is not timely made, Rule 15c3–3(i) requires the broker or dealer to give immediate tele-

graphic notice to the Commission, SIPC, and "the regulatory authority for the broker or dealer, which examines such broker or dealer as to financial responsibility * * *."

On October 31, 1974, the District Business Conduct Committee for NASD District No. 6 issued a complaint (Supp. App. 1–2) charging that petitioners had violated Rules 15c3–3(e) and 15c3–3(i). The complaint alleged that petitioners had not made special reserve account deposits required by computations performed at the end of January, May, and June 1974. The complaint further alleged that petitioners had not given the required notice of their failure to make the necessary deposits.[2]

After a hearing, the Conduct Committee determined that the charges in the complaint were justified. The Committee found that, although petitioners' own computations had shown that deposits were required under Rule 15c3–3, petitioners had failed to make the required deposits and had failed to give notice that necessary deposits had not been made (Supp. App. 70–80).

Petitioners argued that, while their original computations had indeed shown that deposits were required for January, May, and June 1974, subsequent corrections revealed that no such deposits were in fact necessary for the first two months at issue. With respect to the June 1974 deposit, petitioners explained that the failure to make the deposit in timely fashion (*i.e.*, by the morning of July 2, 1974) was attributable to the July 4th holiday and a short vacation taken by petitioner William Whiteside (Supp. App. 75).[3] Upon examination of the relevant figures, the Committee determined that the amounts of the neglected deposits were not as large as initially alleged in the complaint. Even so, the Committee found that petitioners had failed to make required deposits in excess of $10,000 for January 1974, $14,000 for May 1974, and $43,000 for June 1974.

The Committee did not accept petitioners' explanation for the delay in making the June 1974 deposit. The Committee concluded that petitioners had violated Rules 15c3–3(e) and 15c3–3(i), as well as Article III, Section 1 of the NASD's Rules of Fair Practice. (The latter provision states that, in the conduct of his business, an NASD member "shall observe high standards of commercial honor and just and equitable principles of trade.") After reviewing all the circumstances, the Committee decided that the appropriate

[2] With regard to the January 1974 deposit, petitioners should have notified the Commission, SIPC, and the NASD. With regard to the May and June 1974 deposits, petitioners should have notified the Commission, SIPC, and the MSE. When the company became a member of the MSE on February 1, 1974, the stock exchange replaced NASD as the regulatory authority charged with the task of examining petitioners' financial responsibility.

[3] After petitioners were contacted by NASD staff members on July 11, 1974, a new computation was performed, and the deposit required by that computation was made in petitioners' special reserve account. Because of a net decrease in petitioners' indebtedness to customers during early July 1974, the deposit necessary under the July 11 computation was approximately half the amount required by the computation performed as of June 30 (Supp. App. 75, 80, 125–126).

penalties for petitioners' violations were censure and a fine of $1,000 plus costs (Supp. App. 76–77).

On petitioners' appeal of the Committee's decision to the NASD Board of Governors (Supp. App. 81–92), a hearing was held before a subcommittee of the Board. Following that hearing, the Board affirmed the Committee's findings and the sanctions imposed. The Board also assessed the costs of the appeal against petitioners (Supp. App. 95–97).

Pursuant to Section 19(d) of the Securities Exchange Act, 48 Stat. 898, as amended, 15 U.S.C. 78s (d), petitioners appealed the Board's decision to the Commission (Supp. App. 98–103). After considering the parties' briefs and oral arguments and the record of the NASD proceedings, the Commission issued an Opinion and Order dismissing petitioners' appeal (Supp. App. 121–127). The Commission upheld the NASD's findings that petitioners had failed to make the necessary deposits for January, May, and June 1974 (Supp. App. 122–123). In response to petitioners' contention that revised computations indicated that no deposits were required for January and May, the Commission found that those computations were based upon an incorrect interpretation of Rule 15c 3–3 (Supp. App. 123–125).[4] Because its opinion in this

[4] Petitioners argued that customers' prepayments for securities not yet delivered need not be included among "cash liabilities" to customers. In rejecting this argument, the Commission referred to the detailed formula for special reserve account computations set forth in Exhibit A to Rule 15c3–3, 17 C.F.R. 240.15c3–3a. The Commission interpreted that formula to require that customers' deposits for the purchase of securities be regarded as liabilities to customers.

case represented its first opportunity to construe the rule's provisions, the Commission decided to exclude the first two omitted deposits from its consideration "in determining whether the sanctions imposed by the NASD [were] excessive" (Supp. App. 125).[5]

With respect to petitioners' failure to make the deposit required by their computation as of June 30, 1974, however, the Commission observed that petitioners themselves have "admit[ted] that * * * a substantial deposit in the special account was required" (Supp. App. 125), but that nevertheless, the deposit was not made and notice of the failure to make the deposit was not given until July 11, 1974. The Commission stated (Supp. App. 126):

> [Petitioners] concede that their failure to make the June computation on time was their own fault. More important is the fact that when they finally made the computation, they did not deposit the amount which a timely computation would have required. In these circumstances, the $1,000 fine imposed by the NASD cannot be considered "excessive or oppressive."

The court of appeals upheld the Commission's decision. The court found that petitioners had failed to make the deposits and to give the telegraphic notice

[5] Section 19(e)(2) of the Securities Exchange Act, 48 Stat. 898, as amended, 15 U.S.C. 78s(e)(2), provides that the Commission may reduce a sanction imposed by the NASD if the sanction "imposes any burden on competition not necessary or appropriate in furtherance of the purposes of this chapter or is excessive or oppressive."

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required by Rule 15c3–3(i). It stated (App., *infra,* 7A):

> The SEC recognized in this case that the excuses expounded by petitioners were mitigating factors in the consideration of sanctions to be imposed. In light of the fundamental nature of the reserve account system to the safeguarding of customers' funds, however, the SEC concluded that the sanctions were appropriate. We cannot say that this conclusion was arbitrary or an abuse of discretion.

ARGUMENT

The decision below is correct and raises no issue of sufficient importance to warrant review by this Court.[6] The court of appeals correctly concluded (App., *infra,* 6A) that the Commission's "finding that petitioners violated SEC Rule 15c3–3 and, consequently, NASD's Rules of Fair Practice, is clearly supported in the record by substantial evidence." The censure and fine imposed as a penalty were neither arbitrary nor excessive.

The record shows that during a telephone conversation with NASD examiners on July 11, 1974, petitioners admitted that a required deposit to their special reserve account had not been made and that notice of their failure to make the necessary deposit had not been given to the NASD (Supp. App. 25–26, 36–37, 83, 86).[7] Petitioner William Whiteside testified at the hearing before the District Business Conduct Committee (Supp. App. 27): "Now, yes, we erred. I am not going to tell you we didn't err * * *." In addition, the telegram sent by petitioners to the regulatory authorities on July 11, 1974, confirmed that "[a]s of June 30, 1974, our reserve account should have had a balance of $59,291.28 instead of the actual $9,051.91 balance" (Supp. App. 65). Thus, the record supports the Commission's finding, affirmed by the court of appeals, that petitioners did not make a deposit to their special reserve account or give notice of their failure to do so until July 11, 1974,[8] nine days after the deposit should have been made.[9]

[6] Petitioners contend (Pet. 1) that this case presents issues of "national importance" because it "is the first interpretation of Rule 15c3–3." The Commission, however, expressly excluded from its review of the NASD sanction that aspect of the case that required interpretation of the formula set forth in the rule (Supp. App. 125). See p. 7, *supra.*

[7] The NASD's telephone call to petitioners was triggered by the NASD's receipt, on July 11, 1974, of petitioner Whiteside & Company's Form M for June 30, 1974. Form M is designed to alert the NASD to potential problems of its members, and the Form M received from petitioners on the date mentioned showed a required special reserve account balance of approximately $50,000 but an actual balance in that account of only $9,000 (Supp. App. 25–26, 69).

[8] On July 11, 1974, after they were contacted by the NASD staff, petitioners deposited not the amount required by their earlier computation as of June 30, 1974, but a lesser amount based on a recomputation of their net credit balance as of July 11, 1974 (Supp. App. 15). As the Commission observed, this procedure "permitted the firm to use $43,793 to which it was not entitled, during the early part of July" (Supp. App. 126). See note 3, *supra.*

[9] Petitioners assert (Pet. 3, 11) that under Rule 15c3–3(e), the time of the required computation is unclear. This argument ignores the essence of petitioners' violation, which was not the failure to make timely computations but the failure to make necessary deposits and give notice of that failure. Rule 15c3–3(e) does not require that the computation be done at a set time, but that the computation be made "as of" the last business day of the

Petitioners' violations of Rule 15c3–3 also constituted violations of Article III, Section 1 of the NASD's Rules of Fair Practice. This point is well established by Commission precedent. See *Barraco and Company,* 44 S.E.C. 539, 540–541; *Valley Forge Securities Co., Inc.,* 41 S.E.C. 486, 488; *Joseph Blumenthal,* 41 S.E.C. 133, 136. Petitioners argue (Pet. 2) that Article III, Section 1 should not encompass violations of Rule 15c3–3, because Rule 15c3–3 is "an internal [rule] for the broker-dealer * * * not involving 'principles of trade' with a customer who is probably unaware of such a bank account." As the court of appeals noted (App., *infra,* 7A), this contention overlooks "the fundamental nature of the reserve account system to the safeguarding of the customers' funds * * *." Cf. *Blaise D'Antoni & Associates, Inc.* v. *Securities and Exchange Commission,* 289 F. 2d 276, 277 (C.A. 5), certiorari denied (368 U.S. 899.

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month and that any deposit required pursuant to the computation be made not later than 1 hour after the opening of banking business on the second following business day. Accordingly, the computation may be performed at any time in the interim between the last business day of the month and the time by which the deposit is required, so long as it is completed in time for the deposit to be made in accordance with the rule.

Petitioners' repeated arguments (Pet. 4–5, 7–8, 10–11) that it was impossible for them to complete the computations in time to comply with the deposit requirements were considered and correctly rejected by both the Commission (Supp. App. 123–126) and the court of appeals (App., *infra,* 4A–6A). In any event, those arguments would not excuse petitioners' violations. Petitioners did not make the necessary deposits even after their computations were completed, and they completely ignored the notice requirement of Rule 15c3–3(i).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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Securities and Exchange Commission.

MARCH 1978.

APPENDIX

WHITESIDE & COMPANY ET AL., PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION, W
D.C., RESPONDENT

No. 76–3318

Summary Calendar*

United States Court of Appeals, Fifth Circuit

Aug. 18, 1977

Rehearing Denied Sept. 23, 1977

Clarence K. Whiteside, pro se.
William H. Whiteside, pro se.

David Ferber, Sol. to SEC, Vernon I. Zvoleff, Atty., David J. Romanski, Asst. Gen. Counsel, Washington, D.C., for respondent.

Petition for Review of An Order Of the Securities and Exchange Commission (Texas Case).

Before THORNBERRY, RONEY and HILL, Circuit Judges.

On October 31, 1974, the District Business Conduct Committee No. 6 (the "Conduct Committee") of the National Association of Securities Dealers, Inc. (NASD) filed a complaint against petitioners, Whiteside & Company, a broker-dealer registered with the

*Rule 18, 5 Cir.; see *Isbell Enterprises, Inc.* v. *Citizens Casualty Co. of New York et al.*, 5 Cir., 1970, 431 F. 2d 409.

Securities and Exchange Commission (SEC) pursuant to Section 15(b) of the Securities Exchange Act, as amended, 15 U.S.C.A. § 78*o*(b), and a member of the NASD, and the firm's two partners, Clarence K. Whiteside and William H. Whiteside. The complaint alleged that petitioners, after computing the "Formula for Determination of Reserve Requirement for Brokers and Dealers" on a monthly basis pursuant to SEC Rule 15c3–3, 17 C.F.R. § 240.15c3–3, failed to make the necessary deposits to the "Special Reserve Bank Account for the Exclusive Benefit of Customers" and failed to notify the SEC, the Securities Investor Protection Corporation (SIPC), the NASD, and the Midwest Stock Exchange (MSE) of their failure to make the required deposits in violation of Article III, Section I of the Rules of Fair Practice [1] of the NASD.

Petitioners denied the allegations of the complaint and a hearing was held before the Conduct Committee. On February 7, 1975, the Conduct Committee issued a written decision finding violations and imposing a censure, a $1,000.00 fine and assessing costs. On appeal to the Board of Governors of NASD this decision was affirmed and the costs of the appeal were assessed against petitioners. Petitioners appealed to the SEC pursuant to Section 19(d) of the Securities Exchange Act, as amended, 15 U.S.C.A. § 78s(d). After argu-

[1] Article III, Section I of the NASD's Rules of Fair Practice requires that an NASD "member, in the conduct of his business shall observe high standards of commercial honor and just and equitable principles of trade."

ment and upon consideration of the record of proceedings before the NASD, the SEC affirmed the NASD's actions and dismissed the appeal. Upon petition for review pursuant to Section 25(a)(1) of the Securities Exchange Act, as amended, 15 U.S.C.A. § 78y(a)(1), we affirm.

Our review on this appeal is not *de novo* but limited by Section 25(a)(4) of the Securities Exchange Act, as amended, 15 U.S.C.A. § 78y(a)(4), which provides that "findings of the Commission as to the facts, if supported by substantial evidence, are conclusive." The SEC is the agency mandated by statute to review the imposition of disciplinary sanctions by self-regulatory organizations such as NASD, 15 U.S.C.A. § 78s(d), and we should not undermine its role by a grudging interpretation of the legislation. This is particularly important in an area of expertise as intricate as the securities field where public interest and public image are very important. Of course, we would be remiss if we simply deferred to the experts and did not insist that decisions be supported by substantial evidence.

The NASD found that computations as of January 31 and May 30, 1974, showed that deposits of approximately $11,000.00 and $14,000.00, respectively, were required to be made in a special reserve account but that no deposits in any amount were made. Petitioners did not contest the fact that no deposits were made, or notice given, but they asserted that "corrected computations" revealed that no deposits were

necessary. The NASD found that, even if petitioners' "corrected computations" were accepted, deposits to the reserve account would nevertheless have been required. Petitioners responded that this was so only because certain cash prepayments made by customers were incorrectly included as liabilities in the determination of the reserve requirement.

The NASD also found that petitioners failed to make a deposit of over $43,000.00, or give timely notice of their failure, as of June 30, 1974. Petitioners' computation of July 8, 1974, indicated that a deposit of over $50,000.000 was required. Instead, a re-computation was made on July 11, 1974, and a deposit of $22,282.22 was made to the special reserve account. Petitioners sought to excuse their failure to make a timely deposit on the basis that one partner was on vacation and a new girl failed to make the deposit. Petitioners also countered by asserting that the failure was cured by the later deposit and that, at any rate, they, in fact, had enough money to cover the deficiency. Finally, petitioners contended that the time lag in the transmission of information to them from the Midwest Clearing Corporation made compliance with the regulatory scheme impossible.

The SEC upheld the sanctions imposed on petitioners. In this regard, however, the SEC noted that this was the first case in which the provisions of Rule 15c3–3 had been interpreted and, therefore, the January and May instances would be excluded "from consideration in determining whether the sanctions

imposed by the NASD are excessive."[2] Thus, our review in this case is limited to the question of whether the SEC's decision that petitioners violated the Rules of Fair Procedure of the NASD is supported by substantial evidence and whether the SEC decision finding that the NASD sanctions were not excessive is arbitrary.[3]

There can be little dispute with the conclusion that petitioners violated Rule 15c3–3. Under the rule small firms, such as Whiteside & Company, are required to compute on a monthly basis their net aggregate indebtedness to customers as of the last business day of the month. Petitioners failed to do so. If the computation shows a net credit balance, the broker-dealer must make a deposit in a special reserve account which, when added to the existing balance in the account, will equal at least 105% of the total credit balance. While petitioners untimely com-

[2] The basis for excluding the January and May instances appears to be that the SEC felt that the regulations were ambiguous enough to render petitioners' exclusion of prepayments from customers in their computations excusable.

[3] Petitioners seem to urge several other points on this court. Most of them do not merit consideration here because they were not raised before the SEC. *See Unemployment Compensation Comm'n* v. *Aragan*, 329 U.S. 143, 67 S.Ct. 245, 91 L.Ed. 136 (1946); *Cotherman* v. *FTC*, 417 F. 2d 587 (5 Cir. 1969). Furthermore, many of those claims are so nebulous that we cannot determine precisely what the issue is, and cannot expect the SEC to do so. One issue, however, reached the SEC and should be addressed here. Petitioners allege that Rule 15c3–3(i) violates their rights against self-incrimination by compelling them to notify the SEC and other regulatory bodies of a failure timely to make a reserve deposit as required by Rule 15c3–3(e). This rule does not violate the petitioners' rights in this regard because 15c3–3 is regulatory, not penal. *See Sloan* v. *SEC*, 547 F. 2d 152 (2 Cir. 1976).

puted a new credit balance, they still failed to make the required deposit. A broker-dealer who fails to make a required deposit is immediately to notify the SEC, the SIPC and other regulatory bodies by telegram. Petitioners did not immediately notify anyone. The finding that petitioners violated SEC Rule 15c 3–3 and, consequently, NASD's Rules of Fair Practice, is clearly supported in the record by substantial evidence.[4]

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[4] One of petitioners' principal arguments, especially as concerns the January and March computations, would have the Commission rule that customers' cash prepayments for subsequent purchases by the broker are not liabilities to customers within the meaning of Rule 15c3–3. The Commission found that such prepayments were such liabilities:

"When applicants' customers tendered their checks, they parted with their money. Applicants' acceptance of those prepayments created liabilities to those customers as of the end of the months in question, and those liabilities were included within the rule's definition of 'other credit balances.'

"Applicants point out that the rule's definition of 'other credit balances,' under which category these prepayments should have been included in the computations, speaks of 'cash liabilities.' They argue that what was owed to these customers as of the end of the subject months was not cash but securities. This argument has some appeal because it is certainly true that the customers' bargains with applicants called for the purchase of securities. However, it is also true that, prior to settlement, applicants held customer funds for which applicants were clearly liable if the transactions were not consummated. Applicants' argument amounts to a semantic distinction which lacks merit in view of the clear import of Rule 15c3–3. Any ambiguity caused by the use of the term 'cash liabilities' in the definition of 'other credit balances' can be readily resolved by reference to Exhibit A to the rule which contains the formula for computing the reserve requirement and which makes it amply clear that 'customers' securities failed to receive' are to be treated as credit balances."

We agree with the Commission.

Section 19(e)(2) of the Securities Exchange Act, as amended, 15 U.S.C.A. § 78s(e)(2), provides in relevant portion that the SEC "may cancel, reduce, or require the remission" of a sanction imposed by the NASD only if it finds that the sanction "is excessive or oppressive." The SEC recognized in this case that the excuses expounded by petitioners were mitigating factors in the consideration of sanctions to be imposed. In light of the fundamental nature of the reserve account system to the safeguarding of customers' funds, however, the SEC concluded that the sanctions were appropriate. We cannot say that this conclusion was arbitrary or an abuse of discretion.

We AFFIRM.

U.S. GOVERNMENT PRINTING OFFICE: 1979